Vietnam – China tensions and its impact on the market

Over the past week's events, the Vietnamese market has been volatile. The VN Index gained 22% in 2013, and a further 20% during the first 3 months of 2014. However, since peaking on 24 March 2014, the index has retreated 16%, 9% of which was lost since the beginning of May.

I. Oil rigs and riots

China's deployment of a state-owned oil rig, accompanied by a flotilla of naval and merchant vessels, in disputed waters 120 nautical miles from the Vietnamese coast near the Paracel Islands, has contributed further to this market volatility. Vietnam claims that the operation violates its 200-mile Exclusive Economic Zone; both nations' claims are motivated by potential oil and gas reserves found in the East Sea (South China Sea).

Adding to this uncertainty were incidents of worker strikes and riots in industrial zones near Ho Chi Minh City on Tuesday evening, 13 May 2014. While initial reports indicated Chinese-owned businesses were targeted, in fact, other Asian-owned, and even Vietnamese factories, were destroyed. As this degenerated into looting and attacks on factory personnel, security forces moved in to restore order. In fact, several factories in the affected areas have already resumed operations while a number of other factories reported that they will re-open on Monday, 19 May 2014.

II. Macroeconomic fundamentals remain

The market, in turn, reacted predictably. With fear being the overriding emotion, local investors, including retail investors (accounting for about 80% of trading volume on both bourses), have been caught up in margin calls as the equity markets declined. According to one estimate, margin loans on the Vietnamese market amounted to USD750 million in April before the incident. When stock prices fall 25 to 30% on average, brokerage houses will rigorously enforce margin calls, thus further contributing to the sell-off.

Additionally, Vietnam's 5-year credit default swaps have risen to 216 basis points, an increase of 5.4% from 205 basis points at the end of April, reflecting foreign investors' concerns over the recent incidents. However, Vietnam's government and government-backed bonds have remained quite stable, with yields fluctuating within a narrow range of 5 to 10 basis points across the entire yield curve as compared to the end of April.

The fundamental features of the economy have not changed: economic production improved in the second quarter of 2014, inflation remains at multi-year lows, and the currency is stable.

- HSBC's PMI reached 53.1 in April, a level not seen since April 2011. This marks the seventh straight monthly rise in the PMI and a substantial spike from 51.3 in March, providing further evidence of the improving manufacturing environment.

- Month-on-month CPI increased 0.1% in April, bringing the year-on-year inflation rate to a record low 4.5%. Recent price hikes in gasoline and diesel fuel will likely impact May and June inflation.
- In April, the State Bank of Vietnam (SBV) announced that foreign reserves reached USD35 billion and its latest projections suggest that the current balance of payments is positive at USD10 billion. Due to these external positions, the SBV maintains its goal of 1% devaluation of the Vietnam Dong against the USD. At present, the official market exchange rate is trading between VND21,135 to VND21,165 per USD, below the SBV's upper band ceiling. However, we have seen the free market rate creep up between VND21,230 to VND21,300 as of 16 May 2014, suggesting the State Bank will be monitoring the situation closely.

Macroeconomic indicators (April 2014)

	2013	Apr-14	2014 YTD	Year-on-year
GDP growth[1]	5.4%			
Inflation	6.0%	0.1%	0.9%	4.5%
FDI (USDbn)	21.6	1.2	3.2	-34.60%
Imports (USDbn)	131.3	12.6	45.1	13.7%
Exports (USDbn)[2]	132.2	12.2	45.7	16.9%
Trade surplus/(deficit)	0.9	0.4	0.6	
Exchange rate (USD/VND)[3]	21,115	21,115	0.0%	
Bank deposit rate (VND)	7.5%	6.5%	-100 bps	

Sources: GSO, SBV, VCB | 1. Annualized rate, updated quarterly 2. Includes gold 3. (-) Denotes a devaluation in the currency, Vietcombank ask rate

Government bond yields (%)

	1yr	2yr	3yr	5yr
April-14	4.82	5.60	6.15	7.19
March-14	4.90	5.75	6.33	7.19

III. Despite volatility, foreign investors are buying Vietnamese equity

To date, the VN Index stands at 524, falling 9% from the end of April. The combined market capitalization of both of Vietnam's bourses now stands at USD49 billion compared to USD54 billion at the end of April. According to Bloomberg, the VN Index now trades on a trailing P/E of 12.4x versus a trailing P/E of 13.9x as at the end of April.

Given these stable macroeconomic fundamentals, foreign investors have taken advantage of Vietnam's biggest stock market retreat since 2001 to boost their holdings in expectation that falling prices due to escalating tension with China prove to be short-lived.

Foreign money managers have purchased a net USD65 million worth of securities across both bourses in May following a net purchase of USD83 million in April. The most acquired companies include PetroVietnam Gas (GAS), Fecon Foundation Engineering and Underground Construction (FCN), and Masan Group (MSN). This makes sense as well-run, profitable enterprises have not changed in terms of operational efficiency or management ability over the past few weeks, even as we have seen their stock prices fall 10 to 20%. For the value investor, the instinct to buy is almost irresistible.

IV. FDI impact – too early to tell

The question remains, what will happen to Vietnam's FDI flows? Domestic demand growth remains weak and a sharp slowdown over the past few years off the back of still-ongoing bank deleveraging has been offset by strong FDI inflows and export-led growth in recent years.

Current tensions and attacks on Asian-owned businesses may eventually impact FDI flows, particularly manufacturing-related FDI. In recent years, China's registered capital inflows into Vietnam has risen, moving to fourth place, with USD2.3 billion or 10.7% of Vietnam's total pledged FDI for 2013. Furthermore, according to Citibank, China remains Vietnam's fourth largest export partner, accounting for 10.2% of Vietnam's total exports, behind the United States (18.2%), EU (18%), and Japan (10.4%), while Vietnam is China's 8th largest export market (2.5% of exports).

Of note, a major Taiwanese multinational announced the suspension of all new investments into Vietnam until further notice. Despite these facts, it is premature to speculate on the full impact of these events on Vietnam's FDI commitments.

V. Economic interests and stability

Continued tensions are unlikely as the situation is already resolving itself. China and Vietnam have been in discussions over this oil rig for the past two years, and in recent days both parties appear to have exercised restraint out at sea. On 5 May 2014, China's Maritime Safety Administration announced that the state-owned oil rig will be in operation for the next three months. While this may not offer any immediate resolution to the current situation, both countries have demonstrated a genuine commitment to resolve this in a peaceful manner given the significant economic interests and desire to safeguard regional and domestic stability.

In conclusion:

- The health of Vietnam's macro-economy and its capital markets have not worsened in any fundamental way.
- The equity market sell-off has been driven by negative sentiment and margin calls.
- Foreign investors, less affected by such sentiments, have taken the opportunity to increase their net purchases of Vietnamese equity.
- For long-term value investors, current trailing P/E levels at 12.4x earnings offer a buying opportunity for Vietnam's equity markets.

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